DOW THEORY LETTERS INC.

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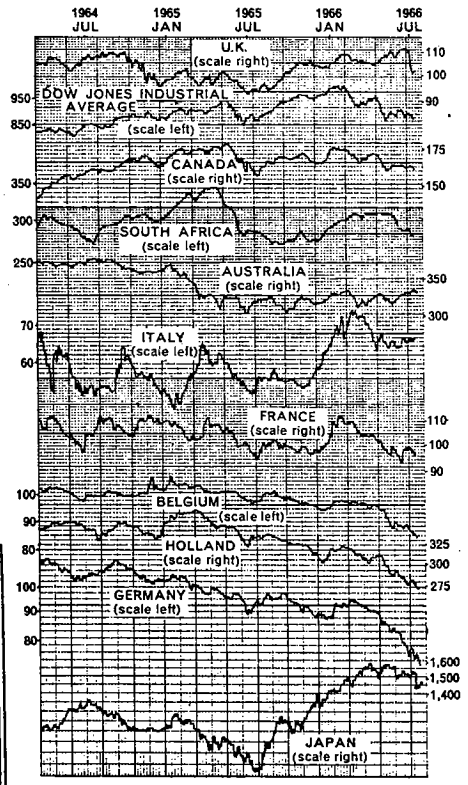
"....And the times, they are a'changin'." (From ballad sung by Bob Dylan).

THE MARKET: Perhaps I should have labeled this section "World Markets." For it is apparent that the American market is finally getting "in gear" with the majority of other security markets around the Free World. Timing the peaks has been difficult if not impossible. Most of the leading foreign nations have had bitter experiences with inflation and "printing press money". They have been unwilling to follow the lead of the U.S. and Britain in monetary matters. Therefore, rather than debase their currency and hold their interests rates down, they have chosen to fight the forces of inflation via higher interest rates and a limited money supply. This has had an adverse effect on their security markets.

For instance, the German and Italian markets topped in 1961, the French market hit its peak in 1962, Switzerland peaked in 1963. I have included two charts which will serve to underline the big picture of stock markets around the world. The graph (courtesy of International Investor, 50 Denmark Hill, London S.E. 5) shows the profiles of 11 leading stock Averages. Only Australia appears to be in an uptrend. The little box of tabulation lists 11 markets and the percentage of each from its all time high of the past few years. At present the markets of Britain, the U.S., Canada, France, Belgium, Holland and Germany are at or very near their lows for the year. A world bear market appears to be developing. This will lead to dramatic and even shocking events over the next year or two. It will also ultimately provide great opportunities for seasoned, patient investors.



Meanwhile, advisory services in this country have been "chaffing at the bit" in their dogged (even frantic) efforts to identify the long-promised summer rally. The highly touted March-April rally turned out to be a failure. The May-June rally proved to be even more of a failure. But rather than accept the big picture (i.e. that a bear market is in force), most of the advisors have continued to exist on hopes. They refuse to recognize the bear market and they refuse to move to a position of safety. This policy has been a costly one. It has cost investors, speculators and the funds billions of dollars in lost assets and profits during 1966.

I view this "bull-headed" attitude as typical and characteristic of the first phase of a bear market (see later section on phases). Despite the recent breaking of the 1965 lows by Industrials, the majority of professional and the public insist that we are still in a primary bull trend. They are largely concerned with thoughts of rallies, recoveries and even "a new try for the February highs."

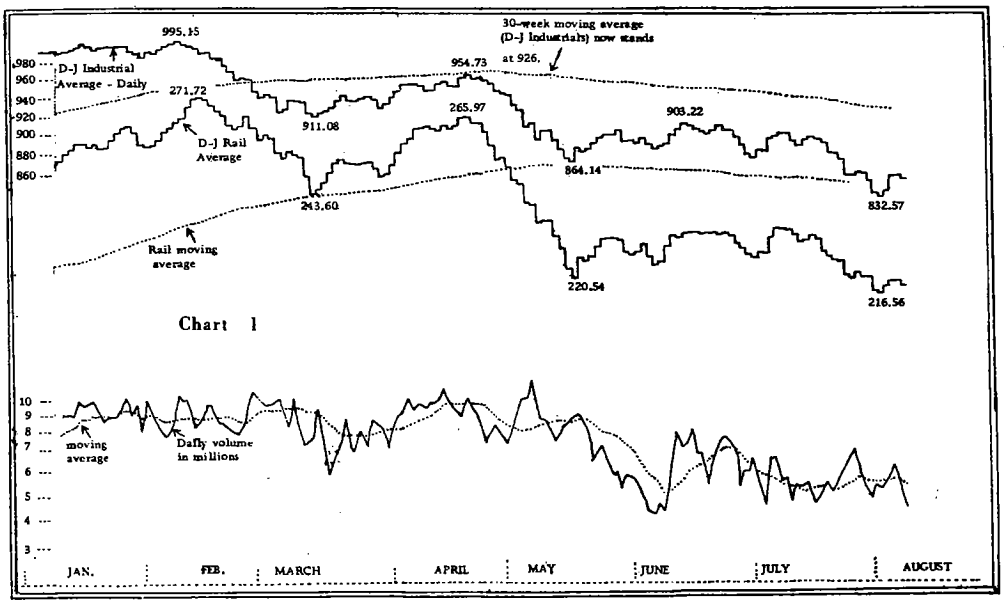


Chart 1

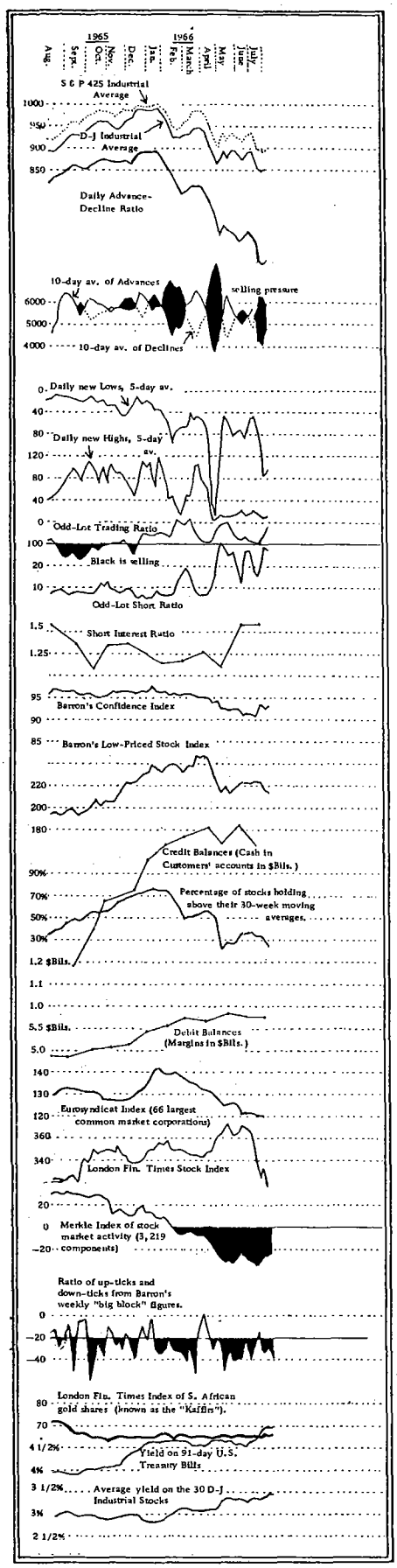
INDICES *	July 27 †	Percentage change from All time High
London	391·6	-12·2
New York	856·2	-14·0
France	97·0	-40·4
Germany	72·9	-48·0
Holland	270·8	-37·2
Italy	66·9	-42·6
Canada	158·0	- 9·2
Belgium	82·7	-23·0
Australia	328·6	-13·3
Sweden	237·7	-11·2
Japan	1,486·0	-14·6

As I said in the last Letter, the outstanding thing about this bear market so far is its utter deceptiveness. It has fooled us all the way down from the February highs. It has managed to keep most people "happy and bullish." Even the breaking of the 1965 lows did not bring in enough fear selling to precipitate a panic. However, it did serve to turn a good many "hold out" investment services bearish. These frustrated gentlemen "threw in the sponge" just before the new rally which started last Tuesday (August 3). They will hardly relish a substantial good upward correction at this time.

But above all, this is what I want my subscribers to consider: regardless of rallies or intermediate recoveries, the bullish stance is apt to produce losses in the period ahead. I continue to urge my subscribers to get into a liquid position rather than try to beat the bear trend by scalping the rallies. A bear market will take your money just as surely as Las Vegas will. The odds are stacked against you. Sure, some people come away from Vegas with "a bundle and a smile," but the chances are that they will lose both on their next visit. A bear market is out to get you; if you keep playing it you must lose. Seasoned investors always stay with the long-term or primary trend. The primary trend is now down.

August 2 represented a particularly interesting day. Here, for the first time during the bear market all four Dow Averages dropped to new lows together with the advance-decline ratio. On that day Industrials sank to their lowest level since August, 1964, Utilities dropped to their lowest level since January, 1963, while the 40 Bonds slipped to a five year low.

A sharp rally followed although August 3 saw a new low on the 40 Bonds. I have said before that bear markets are characterized by "leakage" or first one average and then the other sinking to new lows. Thus despite the fact that the Averages rallied violently on August 3 and 4,



NOTES AND QUOTES: From the London Economist, July 30: "But the thought of devaluation, either as a deliberate policy for the future or forced on a British government by the next weakening of sterling, is now more than ever part of everyday British life. The unthinkable has become very thinkable. Financial decisions of a quite humble order must now take it into account: this is one reason why forward sterling has remained as weak as it has. No other conclusion can be drawn from ministerial discussions in the past two weeks than that devaluation was at issue. It is the policy that underlies the public opposition of that part of the Labour party that is resisting the Government's measures. It is a matter on which Conservative politicans studiously prefer not to pronounce. The conclusion is inescapable."

* * * *

From the Latest (August) Bank Credit Analyst by A. Hamilton Bolton: "The banking figures are again taking a turn for the worse, after mild improvement in the last 3 or 4 months.....Regardless, it is possible to project now the unlikelihood of any improvement in the banking figures such as to provide a firm major buying opportunity in the stock market within the next 6 months. It takes a number of months for the various series to change their trends, and usually these changes are not particularly dramatic, requiring steady and coordinated improvement over a period of months.....As an outside guess we would estimate that once it is recognized that a slowdown is really underway in a significant manner, we will face a situation of relatively easy money overnight. How the economy reacts to this will determine whether a solid base can be constructed in a few months thereafter or whether more serious liquidating forces will have to be experienced."

* * * *

Our current highly-touted "politically astute" Administration is now bogging down. The hands-off attitude towards the airline strike would be humorous if it was not so pathetic. The Administration cannot win here. If they interfere, they will be criticized for coming in too late. If they abstain, they will be blamed for inaction. If they wait for Congress, they will be subject to a charge of "pussyfooting" and playing it safe. Obviously, President Johnson wants the votes this fall, but it is not clear just where they lie. Perhaps sensing the confusion, steel makers have raised their prices, and again ears are strained to catch a sound of Administration censure. The resolution of the steel price increases should provide an interesting commentary on forthcoming Administration tactics and policy.

* * * *

From economist Eliot Janeway's syndicated newspaper column (July 18): "No question about it, Europe is now in for its first post-war slump. We have taken recessions here in stride, and we can take a recession there in stride. What we cannot take is a slump compounded by money troubles, complicated by exchange controls and/or discriminatory taxes, and climaxed by the confiscatory bite of devaluation.

"Our bull market has been feeding these many years on the expansion of the world market--especially for dollars. A forced diet of shrinkage is certain to infect it with pernicious anemia. Exchange controls, discriminatory taxes, and devaluation spell retaliation against Washington's restrictive dollar policies. Meanwhile, during the months ahead, the London market for sterling will emerge as an increasingly sensitive barometer of the New York market for stocks. It is a disturbingly weak reed for Wall street to lean on now."

* * * *

In an interesting article in the current (July-August) issue of the Financial Analysts Journal, Barton M. Biggs pokes holes in the theory that the trend of the short interest in individual stocks is meaningful. After testing 33 stocks, Biggs concludes ".....there is no meaningful correlation between the short interest trend theory and the price action of stocks. In fact, 16 of the 33 stocks performed in a manner exactly contrary to theory, while only 14 behaved as they should have. In 3 cases the evidence was mixed with no conclusive trend either way." Finally, Biggs states: "In conclusion, based on this study, it does appear that the investor and analyst must rely on his tools of fundamental company and industry analysis and not be involved with the trend of the short interest. The trend of the short interest may be intriguing but it is not particularly indicative of anything."

it was not impressive to see a new low on the 40 Bonds during the rally. Sooner or later all primary movements (in this case primary downward movements) are interrupted by secondary corrections of 1/3 to 2/3 of the ground lost. Whether such a rise is now in the offing no one can say, but it does seem to me that further important downside action may be seen prior to the inevitable upward correction of the entire decline since February, 1966. Again I warn subscribers not to get caught up in the short-term picture. It is the big picture which we are concerned with today.

PHASES: In the last Letter I touched upon the matter of bull and bear market (psychological) phases, and I want to go further into phases at this time. Both bull and bear markets tend to develop in three phases, and these phases have nothing to do with price action. Often, for instance, a bull market's second phase may include two or three or more major price rises, each interrupted by a secondary reaction.

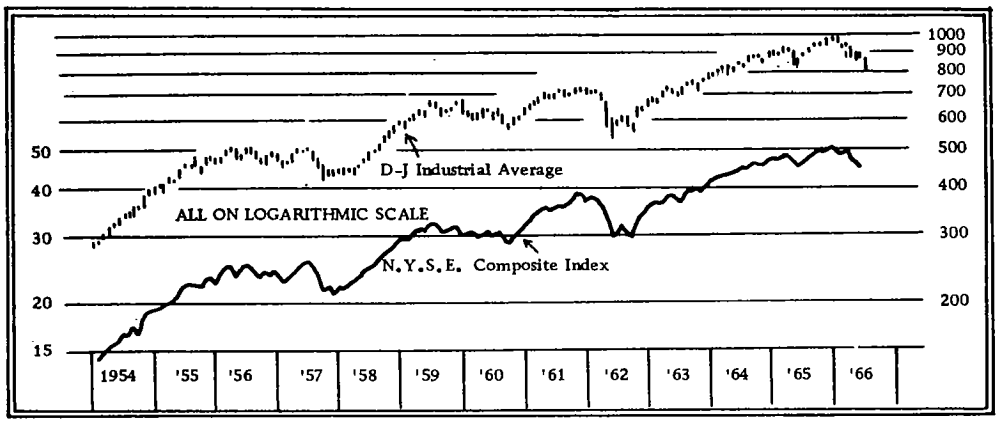
Following is the way the phases may be classified. In the first phase of a bull market stocks rebound from the extreme depression of the previous bear market bottom. In the first phase of a bull market the public is usually bearish, and their influence on the market is minimal. The first phase of a bull market is characterized by the equity accumulation of large and informed interests. The second phase of a bull market is usually the longest phase. Here the market advances in response to obvious signs of economic improvement. The newspapers are publishing increasingly optimistic reports about the business world, and the public is slowly returning to the market. The second phase of a bull market often ends with a violent and deceptive secondary reaction. The third phase of a bull market is the frothy one. The public enters with both feet, optimism reigns, speculation increases and ultimately runs rampant, and "new era" talk abounds. This is the phase in which the crowd becomes very influential, while the true investor tends to become uncomfortable. Towards the end of the third phase, the public takes over and the informed investors distribute their shares. The third phase is the most exciting and most dangerous period of the bull market.

The first phase of a bear market develops out of the final (third) bull market phase. During the first phase of a bear market stocks sell minus the froth of the previous bull market's third phase. Characteristically, the public stays bullish during the first phase of a bear market. They refuse to believe that the tide has turned, and they feel that in time (as was the case during the previous bull market) the Averages will climb to new highs. Thus, even though many stocks suffer substantial losses during the first phase of a bear market, the public tends to hold on to them. As a rule, the business news remains rosy during a bear market's first phase, and this is an important factor in the public's refusal to swap stock certificates for cash. But the large investor is not impressed with the continuing good news. He uses the news as a cover-up and continues distributing his shares.

During the second phase of a bear market the business news does turn bad. Here the financial trouble becomes obvious, and the public is caught "holding the bag." The second phase is usually accompanied by one or more broad panic declines. Many stocks may lose 50% or more of their value during a bear market's second phase, while the financial news moves steadily from bad to worse. Gradually, the public turns completely bearish, and pessimism becomes generally accepted. The second phase of a bear market is generally the longest phase, and (as was the case during the second phase of a bull market), it is often terminated by an explosive and extended (upside) secondary reaction.

All of which leads to the third or final phase of a bear market. Here stocks go down because people need cash (and selling stocks is a way of raising cash). During the final phase of a bear market shares will go below known values, often selling at absurd prices in relation to potential earnings and dividends. Thus American Telephone sold in 1932 at 72, yielding 12½% on its famous dividend and representing a once-in-a-lifetime investment bargain. During the final phase of a bear market large investors begin their quiet accumulation again. The worse the news the better the true investor likes it. Bad news produces bargains on Wall Street, and black news provides great bargains. If the public is doing anything during this final phase, it is simply tossing in its last remaining shares. Gloom is king during the final phase, and the public is adamant in its pessimism. This is the period when great fortunes can be made simply by buying and waiting. Near the final bear market bottom people are no more willing to believe "the coming bull market" thesis than they are willing today to believe that the great bull market is over. Why not try this simple experiment. Tell a Wall Street friend that this is the time to sell out, hold cash, and await the coming economic collapse. Then study your friend's reaction to that statement. He simply will not and cannot believe it. He has been conditioned by the events of the past few decades. And now remember this--at the bottom of a bear market the same psychology will prevail--in reverse.

Where are we now in this bear market? I had felt that a breaking of the 1965 low by Industrials could place us in the potential panic phase of this bear market. "If and when (the panic) occurs," I stated in the last Letter, "I would say that we would be entering the second phase of the bear market." But even the violating of 840.59 last week failed to set off panic action. No question about it, Wall Street is not yet scared and not yet ready to panic. Therefore, the first phase of the bear market continues. The second (or panic) phase lies somewhere ahead. The second phase can be expected to last longer than the first, and the first phase has now lasted over five months.



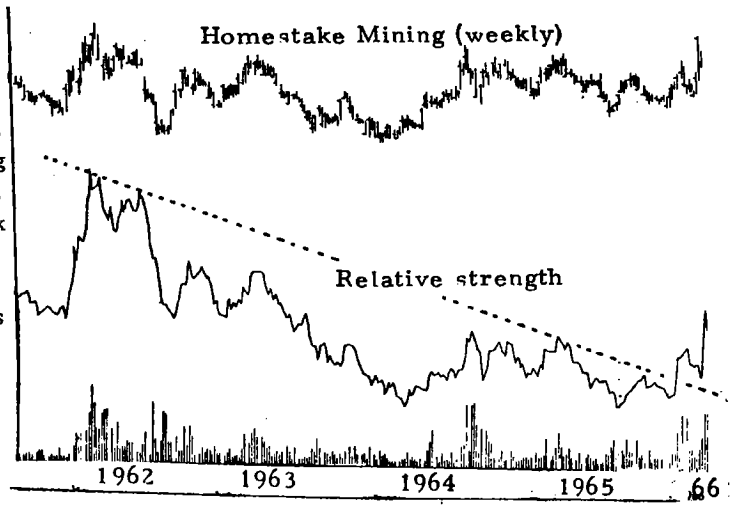
FADS: Wall Street, like New York's garment center, is a street of fads. The fad that has been building up over the past year or so is the "new stock average." While Charles Dow devised the D-J Industrial Average to be a gauge of the price of thirty investment-grade issues, many later market soothsayers have objected to this thesis. The "Dow" is too crude an average, claim some. Others claim that it does not reflect the relative movements of "all stocks." At any rate, over the years a number of stock averages have appeared such as the New York Times Average, the Associated Press Average, the Standard and Poor's Industrial and Composite Averages, the Value Line Average, Investor's Research Average, the Herald Tribune Average, and so on into the night.

The latest (and perhaps the most glamorous) of the Averages is the New York Stock Exchange Composite Average. This Average, brought on only a few months ago, is backed by the power and prestige of the N.Y.S.E. Theoretically, the N.Y.S.E. Average is priced at around the average price of a share on the Big Board. Many Wall Streeters have been disturbed by the large fluctuations in the currently-volatile Dow Average, and it was felt that a fall of say 40¢ on the N.Y.S.E. Average would "look" less scary than a drop of 10 points on the Dow. Furthermore, it was conceded that if the market gets "too high," the new N.Y.S.E. Average could ultimately be split so that its price could be made to look less imposing.

Although the Dow is computed by adding up the price of each of the 30 shares and then dividing by a special adjusted divisor, the N.Y.S.E. Index is composed of more than 1250 stocks, each weighted for the number of shares listed. The remarkable fact about the new N.Y.S.E. Average and the Dow is this: when charted on semi-logarithmic scale (so that percentages of change are shown), the two Averages show almost identical movement both in direction and magnitude. This fact was brought out dramatically when I charted the two Averages, one superimposed upon the other, for a period of thirteen years. A glance at the accompanying chart shows exactly what I mean.

My own feeling is that the whole field of new averages is a "good time" fad, and it is a fad that will not last. I believe that the S & P Averages will last and probably the N.Y.S.E. Average (because of its official backing) will last. But the only Average which has withstood the test of time has been the Dow. Furthermore, the only Average which has its roots in history is the Dow. Every market student knows that the Dow was 381 in 1929, it was 41 in 1932, it was 212 at the 1946 top and it was 161 at the 1949 bottom. This is a most important factor about the Dow--it has an historical frame of reference. When people ask, "Where is the market," one answers, "The Dow is at 850." And that means something. It means something because the frame of reference is clear and it is immediate. "Why 850 is only 149 points from the 1966 high," one answers, "and it is 116 points from the 1961 high of 734." No other Average possesses that type of historical meaningfulness. No other Average, for that reason, will ever replace the Dow in the hearts of market students. When the good times turn to rough times, when some of the organizations which have grown up in boom times decide to shelve their computers and their new averages, it will be the Dow which will again stand alone. It's stood off the competition for six decades, and I expect the Dow to be around for a good many more years.

STOCKS: Following last week's repeat recommendation of Campbell Red Lake, that stock rose to an all-time high above 27. All-time highs are a rarity these days. This week I want to recommend the largest American gold mining company, Homestake. HM has been diversifying and now is only about 50% a gold producer. However, HM has very extensive gold holdings, the largest in the U.S. HM now also looms large as a uranium producer, and the company has contracts to sell the Atomic Energy Commission uranium through to 1970. With the obvious rise of atomic power, this is a hugh plus for HM. HM has many partnerships and among other things HM has large shares in potash, lead and iron ore mines.



The chart (courtesy of Traders Research, 1431 Pearl St., Alton, Ill. 62003) shows HM rising to 55 7/8 a few weeks ago, thereby touching its 1964 high and approaching within 4 points of its 1962 peak of 60. HM has reversed a long downtrend in relative strength, and the stock is now performing considerably better than the market. RECOMMENDATION: I suggest purchase of HM for any accounts that wish a stock which is performing well in a superior group. HM represents a multi-faceted play in gold, uranium and other important metals. HM possesses both defensive and offensive characteristics.